Walter’s Model On Dividend Policy: Explanation, Formular, Example, And More

Economic

Overview

James E. Walter proposed a theory on the dividend policy of a company. It states that a company’s dividend policy depends on the internal rate of return [r] and capital (k) cost.

James Walter offered an interlink between the dividend decision and investment decision of a company. He stated that both decisions are interlinked and cannot be separated from each other.

Although James Walter proposed a useful theory, it resides on several assumptions. Some of its key assumptions are; that an all-equity-funded firm retained earnings as a source of investment, constant EPS/DPS, and constant IRR and Cost of capital (K_e).

Despite some hypothetical points, Walter's dividend policy theory offers valuable guidance.

Let us discuss some key points from Walter's dividend policy theory and see how it relates to real-world scenarios.

What Is Walter's Model On Dividend Policy?

James E Walter suggested that a company's dividend and investment decisions are interlinked.

He proposed that one of these decisions directly affects the other decision. Hence, a company cannot isolate the dividend or an investment decision.

Walter's proposition states a relationship between the internal rate of return [r] and the cost of capital (K_e). Since Walter assumes the source of capital as equity only, we can consider the cost of capital as the cost of equity.

The relationship between [r] and (K_e) suggests that a company should consider both factors before deciding. If the internal rate of return is greater than the cost of capital, it should retain the profits and not announce dividends.

Conversely, if the company's cost of capital is higher than the internal rate of return, it should not retain the profits and distribute them in the form of dividends.

A company's ultimate goal is to increase the shareholders' wealth. It can do it by offering dividends to them or increasing share prices and achieving capital appreciation.

Hence, a dividend announced will come at the cost of reduced retained earnings and lower reinvestments. Thus, a company must follow an optimum way of making the key decisions of dividends and reinvestment of profits.

Formula

The formula to determine the market value of a share according to Walter's model can be written as:

$$P = D/k + \{r \times (E-D)/k\}/k.$$

D= Dividend Per Share

E = Earnings Per Share

K= Cost of Capital or cost of equity

and r = Internal rate of return of the company.

Explanation

The mathematical version of Walter's theory provides the current price of the company's share. According to Walter's theory, the share price of a company is the sum of:

1. Cash flow of dividends, and
2. Cash flow of retained earnings that are reinvested at the rate of r.

Important Scenarios With Walter's Model

In a practical world, a company can be in any growth stage. Hence, its dividend decision can be different at different growth stages. Walter also proposed the same through his theory of dividend policy.

We can link three main scenarios of a company's growth stage with Walter's theory.

Firms In The Growth Stage, When R > K_e

A company in the growth stage has positive NPV projects to invest in. It can only sustain a growth stage if it keeps reinvesting in positive NPV projects. It also means a growth stage company will offer greater returns to shareholders internally than by offering dividends.

Walter proposed that a growth stage company should not pay any dividends to its shareholders. It should retain all of its profits and reinvest them in growth projects. The shareholders will be better off with capital gains through share price appreciation than dividends.

Firms In The Declining Stage, When R < K_e

A company in a decline stage will not have any positive NPV projects. Hence, it will not be able to offer much value to its shareholders by retaining profits. Thus, it should distribute all of its profits to shareholders in the form of dividends.

In this scenario, the shareholders will be better off receiving dividends and investing them elsewhere to receive a higher return on investment.

Firms In The Normal Stage, When R = K_e

The company can choose its optimum dividend policy according to the situation.

Key Assumptions In Walter's Model

Walter's dividend policy theory is based on several assumptions.

- The company uses only internal finance sources such as retained earnings and no external financing neither equity nor debt.
- The internal rate of return [r] and the cost of capital (k) are constant.
- All earnings of the company are either reinvested immediately by the company or distributed to the shareholders in the form of dividends.
- The company has a long working life.
- It assumes that the company's earnings per share (E) and dividend per share (D) remain constant.
- The theory does not consider any taxation, transaction costs, and cost of floatation.

Walter's theory is based on several assumptions. It considers the capital market efficient and perfect. Thus, analysts must carefully evaluate the share prices calculated through Walter's theory.

Working Example

Let us consider a simple working example to understand Walter's dividend policy theory.

Suppose a company ABC has an EPS of $ 10 and a DPS of $ 5. Its cost of capital (k) is 8%.

Let us further assume its internal rate of return is 10%, r > k.

P = D/k + {r ×(E-D)/k}/k.

P = 5/8% + [10% × (10 – 5)/8%}/8%

P = 62.5 + {0.1 × (100)]/0.08 = 62.5+ [78.12]

P = $140.62

Note that the share price will change significantly with the value of dividends. For example, if the company pays all of its earnings in dividends, D = $ 10, the price will be P = $ 125.

Criticism Of Walter's Model On Dividend Policy

Although Walter's dividend policy model presents useful thoughts, it ignores several implications. A company may face several implications in practice that Walter ignored.

Some of the key criticism points about Walter's dividend policy model are discussed below.

- It assumes a company has only retained earnings as a source of finance. In practice, a company can have several other sources of finance such as debt financing, new shares issued, and hybrid securities. Thus, it ignores the optimum capital structure of the company.
- It assumes a company will have a constant internal rate of return and a constant cost of capital. In practice, both of these rates change according to the costs and other factors.
- Walter also ignores the risk factors of a company. A company in a risky situation will incur a higher cost of capital than others.
- Walter also ignores some other practical implications such as costs associated with dividend taxes, transaction costs, and floating costs.

Final Thoughts

Walter's dividend policy model presents useful information on a company's dividend and investment decisions. We can use Walter's model to calculate a company's share price. However, it ignores several realistic factors affecting a company's dividend and investment decisions and share price.

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